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Energy Derivatives: The Likely Impact of Derivatives Regulations on North Dakota Utilities

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ENERGY DERIVATIVES: THE LIKELY IMPACT OF DERIVATIVES REGULATION ON NORTH DAKOTA UTILITIES

CHRISTOPHER A. SCHINDLER*

I would like to welcome all of you back for the beginning of the first of two parts of this afternoon's presentations.[1] Chris Schindler is a partner at Hogan & Hartson[2] in Washington, D.C., and his presentation is entitled, "Energy Derivatives: The Likely Impact of Derivatives Regulation on North Dakota Utilities." Chris represents diverse clients in the energy industry including energy traders and marketers, natural gas producers, storage companies, interstate pipelines, local distribution companies, electric utilities, and a myriad of other clients. I encourage you to read about his extensive practice in the energy law area, and with no further ado, please welcome Chris Schindler.

Thank you. As Professor Fershee mentioned, we were colleagues at Hogan & Hartson. Just to give you a little information about our firm, we have about 1300 lawyers, 500 of which are located in Washington, but in about twelve days, we are merging with Lovells, which is the fifth largest firm in the United Kingdom. So we are only going to have a small 2700-lawyer firm. As with any big law firm with a large Washington practice, we have our share of famous alumni. I would be remiss if I did not brag about a couple. The first, of course, is Professor Josh Fershee, who practiced in our Energy Group for a number of years, and we were very sorry to see him leave. The second is the Chief Justice of the United States

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1. This article is a transcription of Christopher A. Schindler's remarks made during his presentation at the NORTH DAKOTA LAW REVIEW Energy Law Symposium, held on April 9, 2010, sponsored by the NORTH DAKOTA LAW REVIEW, with assistance from the Rocky Mountain Mineral Law Foundation Grants Program.

2. Hogan & Hartson has since merged with Lovells and is now known as Hogan Lovells.

Supreme Court, John Roberts. He practiced with us for about ten years before he left for the D.C. Circuit in 2002, and then, of course, went on to the High Court. I think he has a tenured position there, too, pretty much, as long as he successfully avoids those high crimes and misdemeanors.

Anyway, I am very pleased to be in North Dakota—a state that I have never been to. I have to admit I am a little intimidated by all of the other presenters; they are fairly brilliant academic people, and I am wondering what I am doing here other than having a flashback to the finals of my moot court competition.

In any event, as mentioned, I represent a lot of different energy companies, including energy traders and marketers, those that sell bulk power and natural gas and package it with transportation and transmission rights. That necessarily involves a lot of compliance issues—both with the Federal Energy Regulatory Commission (FERC) and the Commodity Futures Trading Commission (CFTC). With respect to compliance issues, I can tell you, that business has been booming ever since the Enron days and it continues to be vibrant. Because this can be kind of a complicated topic, I thought the first thing I would do is give a little background before we go on. A lot of clients and utilities rely on over-the-counter (OTC) derivatives on a regular basis. I thought I would be ambitious and give you a summary of eighty-eight years of commodities regulations, explained in two minutes or less. And to ensure my success, I am going to skip the first fifty-two years when commodity futures were regulated by the Department of Agriculture. The big news happened in 1974 when the CFTC was created. It was an independent agency with jurisdiction to regulate futures trading in all commodities. Congress also overhauled the Commodities Exchange Act at that time, changing it significantly.

So, what is a commodity? They were defined in terms of agricultural products and all other goods and articles, which now include energy products, natural gas, oil, electricity, and things like that. Notably, it does not include onions. I am not kidding about this. Wheat is covered. Corn is covered. Onions were specifically exempted, and I am excited because I am sure there is an excellent law review article that could be written on this topic. For history buffs, it was Representative Gerald Ford that wrote the legislation to appease some irate farmers that were concerned about potential cornering of the market in onions, or something like that. The mission of the CFTC, which will be most relevant for my discussion, is to ensure the economic integrity of the commodities, futures, and options markets, and to provide a means for price discovery and offsetting price risk, to protect the public. For the most part, the CFTC regulates commodity futures transactions on regulated exchanges—in what are called

designated contract markets, or DCMs. Some you have heard before include: NYMEX (the New York Mercantile Exchange) and the Chicago Board of Trade. When futures transactions are conducted on these exchanges, the CFTC plays a significant role in regulating all market players. The types of regulation include the full gamut: there are reporting requirements, record-keeping requirements, the CFTC can establish position limits which tell companies they can only buy so many contracts up to a certain point (a "hard limit"), there are anti-market manipulation provisions, and not surprisingly, fraud provisions. There is pretty pervasive CFTC regulation when you are trading on these designated contract markets.

Things began to change with the Commodity Futures Modernization Act, which, for the most part, exempted regulation of certain over-the-counter transactions that were conducted on electronic trading platforms. Over-the-counter transactions are bilateral transactions between two private parties. They are not conducted on a regulated exchange (DCM), but they may be conducted on electronic trading facilities. The biggest at the time when this really started to catch on was Enron Online. There was a lot of trading that occurred between people, which was largely unregulated as a result of this legislative change. This became known as the Enron Loophole because there were enormous volumes that were transacted on this private trading platform and, of course, there eventually were allegations of market manipulation and ties to the California Energy Crisis, and a whole parade of horribles directed at Enron. The OTC market was growing quite a bit on these electronic trading platforms. Although Enron Online ceased to exist, ICE, which is the Intercontinental Exchange, became a significant player. Trading volumes on ICE have become very significant. These electronic trading platforms, like ICE, were deemed to be "exempt commercial markets" (ECMs) so the CFTC did not have much authority to regulate them. But, these exempt markets were creating derivative products that would mimic the types of futures contracts that are actively traded on DCMs, like NYMEX. In short, they would create what amounts to a NYMEX natural gas futures "look alike" contract that settles at the Henry Hub in Louisiana; in essence a derivative of a NYMEX contract.

People were using these platforms more and more, and it became apparent that as the volume grew and because so many of these contracts were tied to contracts on designated exchanges, the exempt contracts began to impact not only NYMEX prices, but also the prices of the underlying physical commodity markets—the cash market—that is, the daily physical market for commodities. So, in 2008, Congress said, "All right. Let us step in and close the Enron Loophole." And when you say "the Enron Loop-

hole," it creates all kinds of political sensation and helps get legislation moving. And it did. So, Congress closed the loophole . . . *sort of*. Congress basically said, if you can show that a particular over-the-counter derivative contract on an electronic trading platform is significantly impacting NYMEX prices and even the underlying physical commodity price itself, then the contract should be regulated by the CFTC. The derivative product would be deemed to be a "significant price discovery contract," or SPDC. I will not go into all the details, but basically, the CFTC, for the most part, has the same regulatory authority over contracts deemed to be SPDCs that it has with respect to contracts being traded on DCMs such as NYMEX. But, the CFTC must first go through a regulatory process to determine which contracts will qualify as an SPDC before it can regulate it. So, that is important to utilities now because one contract for natural gas has been declared to be a SPDC, and there are forty-two others that are currently being evaluated. It is of importance because there will be requirements for both buying these products and reporting them that will impact utilities as we go forward.

Another issue, which I am not going to get into the details of here, is the CFTC is proposing to establish energy-related position limits where they had before left this up to the exchanges, like NYMEX. The CFTC may put hard limits on the amount of the transactions any individual or company and its affiliates can purchase. This was largely an outgrowth of the oil price spikes where everybody in this room was paying $5 for a gallon of gas. I do not know if that happened to you all, but the price of oil went way up and everybody was thinking, "you know, it is because of speculation," so the CFTC is proposing to put speculative limits on the volume of open contracts. Utilities do not so much take speculative positions, but it could impact the liquidity of these contracts and hence the price, so it should be of interest to utilities. But none of that is really what we are here to talk about; the big ticket item, which is the potential financial reform of the over-the-counter derivative markets.

We are going to talk about the "D" word—derivatives—which most people now, at least in the press, think of as synonymous with almost all of the ills and problems that happened with the 2008 financial crisis. This is because of credit default swaps and mortgage-backed securities and all the types of products that were traded over-the-counter. But, the important thing to understand is there are other types of energy derivative contracts that play a vital role in our energy industry and economy that are used every day by utilities, by generators, and by natural gas local distribution companies and their affiliates. At its core, a derivative is simply a contract whose value is linked to changes in some other underlying variable, such as

a commodity. You know, an obvious example is a futures contract that is on NYMEX. It is a derivative even though it is on the exchange. You are agreeing to buy natural gas in the future at a specific price, and then you are guaranteed to be able to buy it at that price because someone has to sell it at that price. It is, of course, important for companies to have some certainty over what prices they can expect for their commodity.

There are two principal uses of derivatives—or two means of what people use them for. One is speculation, which is profiting on future trends, rates, and prices; gambling if you will. There are traders that gamble on the price, and they use many of these over-the-counter derivatives for speculative purposes. The other is hedging, where a company wants to manage its business risk of volatile commodity prices, and utilities use derivatives for hedging every day. This is important to utilities so they can lock in prices. They can obtain rate certainty for their product. There are a variety of complicated derivatives utilities use to ensure their prices remain stable, which ultimately can create efficiencies that impact the price of energy; so it is important to utilities and the economy.

The two principal markets where these derivatives are traded, purchased, and sold are on the regulated exchanges we talked about. These are designated contract markets like NYMEX. But, the other market which is of significant importance, is the unregulated, over-the-counter market. And again, the over-the-counter market is simply a market where companies and financial institutions enter into private bilateral agreements, usually involving a dealer. Dealers would typically be large financial institutions like Morgan Stanley, Goldman Sachs, Citibank; all the major players you would consider. They act as the middleman putting these transactions together, but the OTC market is not transparent and so you do not know how much activity is occurring or at what price. There is certainly not a lot of price discovery. So, what are some examples? These are not complicated examples, but I wanted to give you a couple of examples of how over-the-counter derivatives are used by energy companies on a day-to-day basis. Let us take a generator that has debt financing, for example, and it needs to guarantee the price of its output even though it is selling as a merchant plant (not pursuant to a long-term power purchase agreement). It needs to get $40 a megawatt hour in order to service its debt, but the market might be $50 a megawatt hour, at that point, which is good; however, the bank knows the market could be $30 a megawatt hour four days or a month from now. How does the generator guarantee it can get the $40 that it needs to service its debt? Well, it might enter into what is called a put option that gives it a right to sell its power output for $40, no matter what happens to the price in the future. So, it will go out, and if the price drops to $30, it is

not a problem because it exercises its option, and it get to sell its power for $40 per megawatt hour, which is what it needs for its debt service, and what the banks want. What if it goes to $60? It does not exercise its option. It can sell its output and get its $60 and just eat the cost of the premium for the option. That is one way it could use these over-the-counter derivatives. It would go to a dealer for this and it would find another counterparty that has an opposite position, and that is how it is put together.

Another one: We talked a lot about wind projects earlier today. Well, if you have a wind project, many of them have power purchase agreements, but some may be merchant generators and would sell into the daily floating market. They would take their output, sell it, and they do not know what the price is going to be because the price is floating in the daily market. But, they need a fixed price because they are trying to get a project financed and the project sponsors need to know they can lock-in a particular price. There are instruments called fixed-for-floating power swaps, which allow the generator to sell at a fixed price and it guarantees such, but the generator only pays the daily price at which it is selling. I cannot explain these all in great detail because I went to law school and I understood then that there was no math involved. My clients rattle off all these things and I shake my head and say: "Can you just give me some easy ones that I can translate." But in any event, the point is there are many different variations of this. They are very important to utilities, generators, and local distribution gas companies that want to lock in prices. And obviously, for power plants that run on natural gas, they want to have a guarantee of what price they are going to pay for fuel. So this is done in the over-the-counter market all the time and they use highly tailored products and contracts.

Let us turn to "the world according to CFTC Chairman Gary Gensler." He is currently advocating significant reform of the financial over-the-counter derivatives industry, not surprisingly. I saw him speak, and met him a few weeks ago in Washington. He is a very bright guy and a very nice guy. He was the youngest, I believe, partner at Goldman Sachs ever. I have a feeling he is doing this government job on a pro bono basis or at least he is taking a significant pay cut. This is how he views the world: the 2008 financial crisis is one of the worst things that has happened to our economy and over-the-counter derivatives played a large role in causing it. Nobody really disputes that aspect of it. However, there are many types of OTC derivatives: credit default swaps, interest rate swaps, mortgage backed derivatives, products between financial companies, and Wall Street-type of products. These swaps are not necessarily the energy transactions I have been talking about. But between 1981 and 2008, the notional value of these over-the-counter transactions went to something like $300 trillion

from $1 trillion. But the market was opaque, so you did not really know this at the time. Suffice it to say the market was big, and because they are transacted through dealers, there is a lot of interconnectedness. You wind up with the problem of "too big to fail" and "too interconnected to fail" because all of these major companies are now trading these over-the-counter derivatives, and the over-the-counter markets do not always require collateral. The institutions often took the credit risk to ensure the deal worked, but they did not necessarily put up cash or adequate security. They relied on the fact that the parties would likely perform and not default. And as a result, these large uncollateralized transactions got bigger, and bigger, and bigger, and as we all know, that practically brought down the economy. So, Chairman Gensler wants to, not surprisingly, reform the OTC derivatives market.

What is he proposing? The first thing he is proposing is to regulate the dealers in these over-the-counter transactions. Let us make the dealers post margin to guarantee performance and maybe also give the CFTC the authority to set position or aggregate limits so we can check how big or exposed the players are. In addition, if we are going to trade these products, let us move them to an exchange or a regulated trading facility so everybody knows the price of these products, and so there is adequate price discovery. If you bring the products to a regulated exchange, it should add to transparency, and he believes, of course, the more competition the lower the cost, etcetera. The third thing, and this is of particular importance to utilities and other energy players, is he wants to have everyone bring the OTC derivatives transactions to clearinghouses, in other words, there will be a mandatory clearing requirement on regulated exchanges or clearing organizations. And what a clearinghouse does is this: if you take your bilateral transaction that might otherwise be conducted between dealers and you take it to a regulated clearing exchange, you have to post margin; that is, you have to put up money at the time you bring it to a clearing exchange so that if there is a default, the transaction will be covered. It is basically a guarantee of performance. So, Chairman Gensler's idea is that, let us bring the transactions to a regulated exchange to help prevent the risk of default. The bottom line is that if companies like AIG had been required to post-collateral, if it had to put up cash or other value at the time it entered into all these credit default swaps, it would have run out of money long before the problem had grown to the point where it jeopardized the economy. Instead, what happened was there was nothing to back-up the transactions, everything did default, and because entities were too big and too interconnected, there was little to do other than get bailed out by the federal

government. The statistic is something like everybody in this room has contributed $600 to the AIG problem.

There does not seem to be much disagreement about the fact that some kind of reform needs to take place. The question is what form will it take, and one significant issue is whether there should be an end-user exemption. Chairman Gensler does not favor an end-user exemption. What is an end-user exemption? Energy companies are end-users of these derivatives. They are using them to hedge and mitigate their commercial risk. They are not just trading them and pushing them around for speculative purposes, like some Wall Street players. They use them as part of their business. So, these energy companies believe there should be an exemption so they do not have to bring all of their transactions to the exchange for clearing, which requires the posting of collateral. Chairman Gensler has said he understands the argument, but thinks we are better off if everybody has to clear on exchanges. It sounds reasonable. So why are the utilities not behind this? There are other issues, perhaps unintended consequences, that may drive costs for utilities, and ultimately for the prices that are paid for energy costs. Many, including EEI (Edison Electric Institute, the trade association representing many utilities), challenged this requirement. They said, "Look, you are right. The financial meltdown in 2008 involved issues of 'too big to fail' and 'too interconnected to fail.'" But, they argued *energy* over-the-counter derivatives were not part of that. Electricity and natural gas derivatives represented but a tiny fraction of the derivatives market and they were not the ones causing all of the problems. So, we should not be required to clear our transactions on exchanges.

Okay, why not? For one thing, when you bring these instruments to exchanges, they will need to be fairly standardized agreements and there is a lot of flexibility needed in the energy industry in order to tailor products—these derivatives—to the specific needs of each company. You may have a power plant that needs financing for ten years. A lot of standard derivatives would not necessarily go out for ten years. Requiring standardization means you might restrict the ability to develop customizable over-the-counter derivatives. Without such flexibility, companies may not be able to get bank financing because there may not be the pricing security to provide secure cash flows that would give banks enough comfort to finance the project. Perhaps an even larger issue is the issue of the collateral that is required when you bring these transactions to clear. The whole point of a clearinghouse is that the clearinghouse is the middleman; it guarantees performance. There is no credit risk at that point. And how can they do that? Because parties have to secure with collateral, or more importantly, margin. With margin, you have to secure with collateral when you first

bring your transaction onto the exchange, and the amount changes over time because the value of the contract changes over time. Margin is cash, and not things like non-liquid assets; for example, a physical plant. In the OTC market you did not always have to secure with collateral. Utilities are fairly credit worthy; most of them. They often use their own balance sheet to provide the kind of security that is necessary for credit risk. Or, maybe they put up some plant and equipment, or maybe they put up some other type of asset. Such non-liquid assets are not typically the types of things that you may bring onto the exchange that will satisfy as collateral. And, if you have to put up cash, is it the cash that would otherwise be used to build more transmission lines? More plants and infrastructure? So, utilities are very concerned about getting an end-user exemption, and want to leave the mandatory clearing for the Wall Street firms that got us in this mess. This debate is percolating on Capitol Hill. I will not go into the details, but the House has a version, the Senate has a version, and I think ultimately we are going to wind up having an end-user exception, at least that is the current thinking. Senator Lincoln of Arkansas has a bill, that supposedly has bipartisan support, coming out this week, so stay tuned for that.

Lastly, a quick talk about financial transmission rights (FTRs)—these are a hot issue for utilities too. An FTR is a product designed to allow utilities to manage congestion on transmission lines. Transmission lines sort of function like a garden hose that gets kinks when you have congestion. So, you cannot put your power onto the grid in certain areas and may not be able to get it to others, and this affects the value which is paid for your power. But, generators and utilities can buy these FTRs, which will allow them to recoup some of the money lost due to congestion. FTRs are used frequently, and it is an important product in the industry. They are also highly regulated by the FERC, by the Regional Transmission Organizations (RTOs), and the Independent System Operators (ISOs). There is already pervasive regulation, but the CFTC would like to regulate the FTRs as well. The industry does not think so. What is clear is that Congress needs to clarify the ambiguity because it is in a limbo state where nobody is sure who has jurisdiction and where the FERC's jurisdiction cuts off and CFTC's begins.

I think I can wrap up with a little bit more on cap and trade. I am not going to get into it too much because I think we have an excellent panel on that, but the trading aspect I did want to mention because the emissions trading component itself will be regulated, but by whom? I am not talking about the EPA making sure the emissions credits actually account for the greenhouse gases for this plant, i.e., the integrity of the credits themselves. I am talking about the market and the trading of emissions allowances, and

making sure there is no market manipulation. It is important to get it right because you have a balance between wanting to make sure you guard against manipulation, and ensuring you have an efficient and liquid market that works well because that is what is going to keep costs down. The market is going to be huge, though, and there are some estimates that within the first five years the market could grow to $2 trillion of traded emissions allowances. That is big. And no doubt there will be creative products trading. Who is going to regulate the market? Well, the FERC could do it. Some bills in Congress, the Waxman-Markey "ACES" Bill, for example, has the FERC handling the spot market for the trading. This corresponds to the FERC's authority for natural gas and power. The FERC has authority over the wholesale physical market, the spot market, whereas the CFTC would have regulation of the financial market, i.e., futures and other financial instruments related to the emissions transactions.

The Senate has bills that tend to lean towards having one agency regulating it all. There is one bill, I think it was the Feinstein-Snowe Bill, that explicitly says the CFTC will have full authority. There are pros and cons to both. The FERC has a lot of experience regulating utilities. The utilities are used to dealing with the FERC, so the FERC could have a meaningful role. My clients certainly think the FERC has a vigorous and robust enforcement office, with a $1 million a day penalty authority. The FERC has a market monitoring function, but the CFTC has an extensive and sophisticated market monitoring function too. Chairman Gensler, to his credit, is putting on a "full court press." He believes the CFTC should have oversight authority to regulate the trading aspects of a cap and trade program. The FERC has had a tepid response, with an attitude that, "Well, we can certainly do it, but . . . ." Chairman Wellinghoff said there are many things he would rather have, like a national renewable portfolio standard siting authority, and also noted it would take a lot of changes and new hires to get it in place. Some have said it would be good to have two agencies regulating the market. Is it good to have two agencies regulating? Some people would say it gives you an extra backstop for guarding against manipulation. Others note it would create a lot of confusion about where one jurisdiction stops and the other begins. Such confusion, of course, is good for me because my job is to explain to clients, on an hourly basis, exactly how that shakes out. So, the more confusion, the better. But from the industry perspective, I do not think they want to see it that way.

Anyway, that wraps up what I have to say. I am happy to take questions. I cannot guarantee I will be able to answer them all, but I am certainly willing to try. Anyone? Yes.

Perhaps I misunderstood you, but are you saying the floating power swaps are asset-backed or not asset-backed?

It depends, they can be if they are over the counter, then maybe . . .

Not required.

It is not always required. If you go to a dealer and you are doing these transactions, you may or may not be required to put up collateral. Sometimes there may be collateral, but not cash collateral, or it may not be required at all. It depends on the agreement in each transaction. The other point is that right now you can clear over-the-counter transactions on regulated exchanges on a voluntary basis. They have a clearing function and people do not always use it, but if you want to, it is available. You can use it to guarantee the parties will perform, but it can be more expensive because of collateral and margin requirements.

Can I have a follow-up question to that?

Oh, please.

Who are the players that are floating those derivatives and then who are the insurers insuring the derivatives?

A utility might purchase them, but there are other players . . . like financial institutions involved. Sometimes you can have simply two players, a buyer and seller of power, that might agree. But, more often than not, there is a dealer, which is a large financial institution that gets involved who is betting on the other side. In other words, the financial institutions have other positions they can hedge so they are willing . . . somebody wants to buy daily market or wants to buy the floating market price and somebody else wants it fixed, and somebody makes money off the spread. But for that cost, they get a guarantee of a locked-in price. I am not sure I have answered your question . . . . I am not sure I fully understand it.

What role does Senator Dodd's decision not to seek re-election play in this whole debate.?

We will know more next week, but I do not think it is going to have a huge impact if they can get financial services on board . . . and by the way, the OTC derivatives section is just a small portion of the overall financial reform bill. Dodd is on the banking committee. He has a couple of people trying to get bipartisan support, with Jack Reed and Judd Greg, who did not reach an agreement, so he has one bill that is already out there. What I have been told is that the chairman of the Senate Agricultural Committee, Blanche Lincoln, has what she believes to be a bipartisan bill focusing on the derivatives portion which is supposed to come out this week, so it may be going without him. I do not think the fact he is not seeking re-election will necessarily change the strategy. I think it is a big ticket item. It is going to be interesting to see. Yes.

You say predictions here and . . .

Yes. Prior to the passage of healthcare, the consensus of our legislators and people in our law firm was that there is not going to be anything, certainly not this year, in an election year on a climate bill. Now, with the passage of health care legislation, there seems to be a little more excitement. I think the next panel may have a better prediction than I may have. I am skeptical. We may get one. I still do not think we are going to get one this year. Whether we get a climate bill after the election is hard to predict because there are all kinds of predictions about how things might swing after the election in terms of numbers in Congress. To add a spin on that, I get asked this sometimes: "Well, if the FERC does not really seem to want jurisdiction, or certainly is not exactly putting on a 'full court press' to get jurisdiction over cap and trade, then why is the FERC in the mix for being the regulator?" And the answer, of course, lies in our Congress. The FERC jurisdiction lies with the Energy Committee and the CFTC is part of the Agricultural Committee's jurisdiction, and the heads of those committees like to preserve power and authority to be the chief regulator, which is my own personal view. I do not want to be cynical, but you cannot ignore that companies subjected to regulation by a particular committee tend to give campaign funds and donations to the people who are actually regulating them. That is a reality of the way our politics work. You may have somebody whose committee thinks the FERC ought to be the one with jurisdiction, whether the FERC agrees with it or not, because it is their committee. The next group may have more insight into the predictions than I do on climate change. I was looking for *your* predictions. I did not think *I* was supposed to give predictions. Anyway, thank you. Anything else?

Well, thank you very much for being here. And one more thing, I am particularly glad to be here because I have now made it to North Dakota. That leaves me with one state left in the Union that I have not been to—Nebraska—and I was not sure when or how I was going to get to North Dakota, but I am thrilled to be here. I do not know how or when I will get to Nebraska, but I will get there.